

# The Conflicted Advice Problem: A Response to Conflicts & Capital Allocation

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## I. INTRODUCTION

Professor Benjamin Edwards’ *Conflicts & Capital Allocation* is a timely piece that examines the far-reaching consequences of commission-based compensation for financial advisors.<sup>1</sup> In the article, Professor Edwards convincingly demonstrates that commission-based compensation creates structural conflicts of interest for financial advisors who sell their clients financial products that generate higher commissions for the advisor but do not maximize the client’s wealth.<sup>2</sup> But, as Professor Edwards argues, the effect of financial advisors’ compensation-related conflicts extends beyond retail investment clients and into the financial markets, causing systemic capital misallocation. The potential macro-level harm that arises from conflicted investment advice thus requires an effective response. To this end, Professor Edwards puts forward a straightforward, bright-line proposal: a prohibition on commission-based compensation for financial advisors.<sup>3</sup> As Professor Edwards asserts: “[b]anning commission compensation for personalized

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<sup>1</sup> Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 181 (2017). In this Response, the term “financial advisor” refers to investment advisers and broker-dealers, collectively. The difference between the two is delineated in greater detail *infra*.

<sup>2</sup> See *id.* at 184 (“Some products offer the advisors larger commissions, and advisors have an incentive to steer clients toward products that maximize advisor commissions.”).

<sup>3</sup> See *id.* at 185, 209.

financial advice will better align financial advisor incentives with their clients' interest and improve capital allocation."<sup>4</sup> He further opines that a complete prohibition on commissions is the most efficient way to minimize and avoid the harms that accompany a commission-based compensation structure.<sup>5</sup>

Compensation-related conflicts of interest are common in the financial markets beyond financial advisors and retail investors.<sup>6</sup> Credit rating agencies, for example, are paid by the issuers whose debt they are rating, which may incentivize them to inflate ratings in order to attract more ratings opportunities.<sup>7</sup> Similarly, directors set their own compensation for serving on a corporation's board, which allows them to potentially maximize their earnings at the expense of the corporation and its shareholders.<sup>8</sup> Indeed, one need look no further than the ongoing scandal that currently embroils Wells Fargo regarding fraudulent accounts that the bank's employees created in order to meet their quotas.<sup>9</sup> In each example, the compensation structure is innately conflicted, has been viewed as a primary impetus for related scandals, and has resulted in many of the ills identified in *Conflicts and Capital Allocation*.<sup>10</sup>

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<sup>4</sup> *Id.* at 209.

<sup>5</sup> *See id.* at 209, 212.

<sup>6</sup> *See* Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 246–49 (2009) (describing the conflict of interest inherent in the credit agencies). *See generally* Susan E.K. Christoffersen et al., *What Do Consumers' Fund Flows Maximize? Evidence from Their Brokers' Incentives*, 68 J. FIN. 201 (2013) (demonstrating that brokers' compensation increases when brokers are affiliated with family funds and consequently involved in investment recommendations).

<sup>7</sup> *See* Lynch, *supra* note 6, at 247 (“[U]nder the issuer-pays revenue model, the interests of issuers and the interests of the credit rating agencies necessarily coalesce, and the credit rating agencies can make more money by providing their paying customers—issuers—with higher ratings.”).

<sup>8</sup> *See, e.g.,* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 763 (2002) (“The second agency problem in most public companies is that executives might make decisions that maximize their own utility but that fail to maximize shareholder value.”).

<sup>9</sup> *See* Michael Corkery, *Wells Fargo Fined \$185 Million for Fraudulently Opening Accounts*, N.Y. TIMES (Sept. 8, 2016), <https://www.nytimes.com/2016/09/09/business/dealbook/wells-fargo-fined-for-years-of-harm-to-customers.html> [<https://perma.cc/K5TE-65CC>] (“Regulators said the bank’s employees had been motivated to open the unauthorized accounts by compensation policies that rewarded them for opening new accounts . . .”).

<sup>10</sup> *See* Robert J. Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 NW. U. L. REV. 85, 86–87, 89, 94 (2013) (stating that the issuer-pay compensation model led credit rating agencies to play a significant role in the 2008 financial crisis); Allana M. Grinshteyn, *Horseshoes and Hand Grenades: The Dodd-Frank Act’s (Almost) Attack on Credit Rating Agencies*, 39 HOFSTRA L. REV. 937, 978 (2011) (“[T]he Financial Crisis Inquiry Commissio[n] . . . conclu[ded] that the credit rating agencies were among the main actors to blame for the economic crisis . . .”); Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders’ Interests and Promote Corporate Long-Term Productivity*,

However, despite the innate and unavoidable issues that accompany commission-based compensation, the structure seems to be here with us to stay, at least in the short- to medium-term.<sup>11</sup> Thus, in this Response, I consider recent efforts to implement one of the alternatives to commission-based compensation that Professor Edwards raises—namely, the imposition of fiduciary duties or a fiduciary-like standard on financial advisors.

Fiduciary obligations developed as part of the law of equity, specifically in instances in which a person was expected to act as a “trustee” because of her relationship of trust and confidence with another.<sup>12</sup> A fiduciary is one who is granted authority to manage the affairs of the principal and, therefore, is entrusted to further the principal’s best interest in her actions and decisions.<sup>13</sup> Thus, integral to fiduciary obligations is the expectation that the fiduciary act: (i) loyally by eschewing or disclosing conflicts of interest; (ii) with care by acting deliberatively in decision-making; and (iii) with candor by disclosing all material and relevant information to the principal.<sup>14</sup> Recently, there has been legislative and regulatory interest in harmonizing the standards of conduct applicable to all financial advisors, bringing them closer to a fiduciary(-like) standard.<sup>15</sup> The first salvo in the battle to impose fiduciary obligations on

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39 WAKE FOREST L. REV. 971, 974–75 (2004) (describing the compensation structure adopted by Enron’s board of directors, which led to Enron’s bankruptcy); John C. Coffee, Jr., *Shareholder Activism in the Era of Trump: What Strategy Works?*, CLS BLUE SKY BLOG (Nov. 21, 2016), <http://clsbluesky.law.columbia.edu/2016/11/21/shareholder-activism-in-the-era-of-trump-what-strategy-works/> [<https://perma.cc/9P76-9454>] (“A final example this year of incentive compensation producing ethically dubious risk-taking and fraudulent behavior is supplied by Wells Fargo & Co. . . . Under pressure, lower echelon employees opted to cheat to avoid losing their jobs.”).

<sup>11</sup> See Coffee, *supra* note 10 (“Clearly, incentive compensation is here to stay . . .”).

<sup>12</sup> See Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880–81 (1988) (describing the historical development of fiduciary law and obligations).

<sup>13</sup> See *id.* at 882.

<sup>14</sup> See *id.* at 882, 899, 906; see also James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and a Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 11–13 (2012).

<sup>15</sup> See 15 U.S.C. § 80b-11(g)(1) (2012) (authorizing the Securities Exchange Commission (“SEC”) to promulgate rules providing that the standard of conduct for all brokers, dealers, and investment advisers be to “act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice”); see also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g)(1), 124 Stat. 1376, 1828–29 (2010) (establishing the standards of conduct for investment advisers); Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550). The imposition of a fiduciary standard would change the regulatory landscape for broker-dealers, who currently operate under a suitability standard. Registered financial advisors, on the other hand, are already subject to a fiduciary standard. See *General Information on the Regulation of Investment Advisers*, U.S. SEC. & EXCH. COMM’N (Mar. 11, 2011), <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm>

financial advisors came from the Department of Labor (“DOL”), which implemented the “Fiduciary Rule” pursuant to its authority under the Employee Retirement Income Security Act (“ERISA”).<sup>16</sup> And, after the Fiduciary Rule failed to come to fruition,<sup>17</sup> the Securities Exchange Commission (“SEC”) proposed Regulation Best Interest to impose a best interest standard on broker-dealers.<sup>18</sup> Both are efforts aimed at reducing the problem of conflicted advice, enhancing investor protection, and minimizing investor confusion. Yet, as this Response demonstrates, the problem of conflicted investment advice is intractable and persists despite these regulatory proposals.

This Response focuses on these recent efforts to “fiduciarize” or otherwise heighten the standard of conduct applicable to financial advisors and analyzes whether and to what extent the proposed fiduciary(-like) standards minimize the conflicted advice problem. As regulators and industry actors attempt to tackle the innate conflicts of interest that arise in the investor-financial advisor relationship through the imposition of fiduciary(-like) duties, it is necessary to analyze the potential implications of these proposals.

This brief Response first analyzes the applicable legal framework that governs the conduct of financial advisors in providing investment advice to retail customers. The Response highlights the muddled and uneven state of affairs with respect to different types of financial advisors to demonstrate the confusion that retail investors face. Next, it discusses the short-lived and now-defunct DOL Fiduciary Rule and the SEC’s recently proposed rule, Regulation Best Interest. Before concluding, this Response analyzes the implications, both positive and negative, of these proposals for retail investors.

## II. THE LAW GOVERNING INVESTMENT ADVICE

Retail investors may rely on brokers and/or investment advisers<sup>19</sup> to help them decide how to allocate their investments.<sup>20</sup> To the typical retail investor,

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[<https://perma.cc/QCN8-SDBW>] (“[I]nvestment advisers owe their clients a duty to provide only suitable investment advice.”).

<sup>16</sup> See Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Advice, 81 Fed. Reg. at 20,946 (“With this regulatory action, the Department will replace the 1975 regulations with a definition of fiduciary investment advice that better reflects the broad scope of the statutory text and its purposes and better protects . . . beneficiaries . . . from conflicts of interest, imprudence, and disloyalty.”).

<sup>17</sup> See *infra* notes 75–79 and accompanying text.

<sup>18</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,675 (May 9, 2018) (to be codified at 17 C.F.R. pt. 240) (new rule establishing standard of conduct for broker-dealers).

<sup>19</sup> Investment advisers is also spelled “advisors.” This Response opts for the former spelling when referring to investment advisers (i.e., those covered under the Investment Adviser Act of 1940). However, when referring collectively to financial services professionals who work with and provide advice to retail investors, this Response uses “advisors”—e.g., “financial advisors” and “retirement investment advisors.”

there is little-to-no difference between a broker and an investment adviser.<sup>21</sup> Yet, the law makes a stark distinction between the two, particularly with respect to investor protection.<sup>22</sup> Key to understanding why the law treats the two seemingly similar positions so differently lies in understanding how brokers and investment advisers have historically interacted with retail customers. Traditionally, brokers have been considered salespeople and, consequently, they are required only to sell “suitable” financial products to their clients. Investment advisers, on the other hand, provide holistic investment advice to clients and, as a result, investment advisers are considered fiduciaries of their clients. The legal distinction between brokers and investment advisers is considered in greater detail below.

### A. Brokers & Suitability

A simple, yet incomplete, description of brokers is that they are salespeople.<sup>23</sup> A broker is an intermediary between (i) financial firms that create financial products and (ii) retail investors who may want to invest in these products.<sup>24</sup> Brokers are regulated under the Securities Exchange Act of 1934 (“the 34 Act”), which subjects them to SEC oversight (indirectly)<sup>25</sup> and the Financial Industry Regulatory Authority (“FINRA”) regulatory requirements (directly).<sup>26</sup> FINRA regulates brokers’ compensation, training, qualification and, importantly, their responsibilities to and interactions with retail investors.<sup>27</sup> Per FINRA Rule 2010, brokers “in the conduct of [their]

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<sup>20</sup> See U.S. SEC. & EXCH. COMM’N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS i (Jan. 2011), <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> [<https://perma.cc/Z5DJ-Q3RN>] (“Retail investors seek guidance from broker-dealers and investment advisers to manage their investments and to meet their . . . financial goals.”).

<sup>21</sup> See ANGELA A. HUNG ET AL., RAND CORP., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS xiii (2008), [https://www.sec.gov/news/press/2008/2008-1\\_randiabdreport.pdf](https://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf) [<https://perma.cc/K74P-QFDJ>] (finding that retail investors do not differentiate well between advisory accounts and brokerage accounts and have similar expectations for both).

<sup>22</sup> See *id.* at 14–15, 115.

<sup>23</sup> See Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339, 357 (2017) (“[A] broker’s purpose is not to provide investment advice but, rather, to sell securities. Simply put, brokers are salespersons.”).

<sup>24</sup> See HUNG ET AL., *supra* note 21, at xiii, 19.

<sup>25</sup> See U.S. SEC. & EXCH. COMM’N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 5 (Mar. 2013), [https://www.sec.gov/about/offices/oia/oia\\_investman/rplaze-042012.pdf](https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf) [<https://perma.cc/9LPN-EYSY>].

<sup>26</sup> FINRA is a self-regulatory organization (SRO) charged with overseeing the financial markets and enforcing rules that govern the conduct of financial market participants. FINRA is a not-for-profit organization that is not a government agency, but is subject to the regulatory authority of the SEC. See *About FINRA*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/about> [<https://perma.cc/E95N-2V46>].

<sup>27</sup> See *id.*

business, shall observe high standards of commercial honor.”<sup>28</sup> FINRA’s standards of conduct require that brokers ascertain the “suitability” of a security before it is sold to a retail investor.<sup>29</sup> Per the suitability standard, brokers must “know their customer” and “know the security” (i.e., that the broker have a reasonable basis on which to believe that the security is appropriate for the customer at the time of sale).<sup>30</sup> Thus, brokers are prohibited from selling or promoting securities that are contrary to the investors’ preferences.<sup>31</sup> The suitability standard is intended to address the inherent conflicts of interest that brokers face as intermediaries between the markets and retail investors and also recognize the sales focus of brokers in their client interactions.<sup>32</sup>

### B. *Investment Advisers & Fiduciary Duties*

Traditionally, to the extent brokers provide investment advice to customers, such advice is secondary to the brokers’ sales focus.<sup>33</sup> On the other hand, the primary responsibility of investment advisers is to provide investment advice to clients.<sup>34</sup> Investment advisers are not intermediaries between the markets and investors; rather, they provide financial advice to clients and are prohibited from entering into securities transactions with

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<sup>28</sup> FIN. INDUS. REGULATORY AUTH., FINRA MANUAL Rule 2010 (2008), [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=5504](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504) [<https://perma.cc/AK62-633C>].

<sup>29</sup> See Gary A. Varnavides, *The Flawed State of Broker-Dealer Regulation and the Case for an Authentic Federal Fiduciary Standard for Broker-Dealers*, 16 FORDHAM J. CORP. & FIN. L. 203, 210 (2011) (explaining the difference between the standard imposed on brokers under FINRA and the fiduciary obligations).

<sup>30</sup> See FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 11-02: KNOW YOUR CUSTOMER AND SUITABILITY 2 (Oct. 7, 2011), <http://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf> [<https://perma.cc/L98T-CKEE>].

<sup>31</sup> See Wrona, *supra* note 14, at 11, 20 (discussing FINRA’s suitability rule which obliges brokers to recommend strategies and transactions to their clients based on their needs and investment profiles).

<sup>32</sup> See U.S. DEP’T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 121 (Mar. 2008), <https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf> [<https://perma.cc/5M4N-XRSZ>] [hereinafter TREASURY BLUEPRINT].

<sup>33</sup> See Barbara Black, *Brokers and Advisers — What’s in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 31–32 (2005) (explaining the asset-based fee structure which best promotes “customers’ and the brokers’ interests”); see also Certain Broker-Dealers Deemed Not to Be Investment Advisers, 70 Fed. Reg. 20,424, 20,428 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275).

<sup>34</sup> The Investment Advisers Act of 1940 defines an investment adviser as “any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2012).

clients.<sup>35</sup> The Supreme Court has described their role as “furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments.”<sup>36</sup> Investment advisers are regulated under the Investment Advisers Act of 1940 (the “Advisers Act”) and are subject to direct SEC oversight.<sup>37</sup> The Advisers Act imposes disclosure and recordkeeping requirements, governs advertising by investment advisers, and restricts the payment of referral fees, among other items.<sup>38</sup> Importantly, investment advisers are fiduciaries of their clients, which requires them to act in their clients’ best interests at all times and to avoid conflicts with the clients’ interests.<sup>39</sup> Lastly, in making recommendations, it is not enough for an investment adviser to determine whether the investment is suitable for her client.<sup>40</sup> Rather, she is required to consider her client’s financial resources, investment objectives, risk appetite, and investment experience in giving investment advice.<sup>41</sup>

### C. *Blurred Lines*

The sharp legal delineation between brokers and investment advisers notwithstanding, developments in the financial markets and financial services have resulted in a considerable blurring of the line between brokers and advisers. For example, the advent of electronic trading markets has automated trade execution, thereby reducing brokers’ trading responsibilities.<sup>42</sup> To

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<sup>35</sup> See *id.* § 206(3).

<sup>36</sup> *Sec. & Exch. Comm’n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 187 (1963) (quoting H.R. Doc. No. 76-477, at 1 (1939)).

<sup>37</sup> See 15 U.S.C. § 80b-3; see also 17 C.F.R. § 275.

<sup>38</sup> See Wrona, *supra* note 14, at 14–16 (describing the different obligations and restrictions imposed on investment advisers under the Advisers Act).

<sup>39</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471 n.11 (1977) (stating that Congress intended section 206 of the Advisers Act, the antifraud provision, to establish “federal fiduciary standards” for advisers); *Sec. & Exch. Comm’n v. Tambone*, 550 F.3d 106, 146 (1st Cir. 2008) (“Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund and its investors . . .”), *reh’g granted & opinion withdrawn*, 573 F.3d 54 (1st Cir. 2009); *United States v. Lay*, 568 F. Supp. 2d 791, 812 (N.D. Ohio 2008) (an adviser must “act in good faith and in the best interests of its client”).

<sup>40</sup> See Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 725 (2012).

<sup>41</sup> See Steven D. Irwin et al., *Wasn’t My Broker Always Looking Out for My Best Interests? The Road to Become a Fiduciary*, 12 DUQ. BUS. L.J. 41, 50 (2009) (“[A] fiduciary duty sets a higher standard than the ‘suitability rule.’ The centerpiece of the fiduciary duty is the requirement that investment advisers act in the best interest of their clients.”)

<sup>42</sup> See Michael Davis et al., *Ethics, Finance, and Automation: A Preliminary Survey of Problems in High Frequency Trading*, 19 SCI. & ENG’G ETHICS 851, 854 (2013) (explaining that even though intermediaries, such as brokers and investment advisers, still

maintain their value within the market, brokers began focusing on providing investment advice to clients.<sup>43</sup> Brokers, therefore, increasingly resemble investment advisers in their operations, but are able to avoid the more onerous fiduciary obligation standard.<sup>44</sup> The current state of affairs is concerning primarily because of its impact on investor protection. Not only are retail investors unable to distinguish between brokers and investment advisers, but many retail investors expect that their financial advisor (regardless of title) is required to act in their best interest (i.e., as a fiduciary).<sup>45</sup>

Against this backdrop, the U.S. Department of Treasury (“Treasury”) in 2008<sup>46</sup> and 2009<sup>47</sup> recommended harmonization of the standard of conduct imposed on brokers and investment advisers to minimize investor confusion. As Treasury noted in its 2009 Report, financial services professionals that provide investment advice to retail investors, logically, ought to be held to the same or highly similar standards to minimize regulatory arbitrage and investor confusion.<sup>48</sup> Nonetheless, the legal and regulatory gap between brokers and investment advisers persisted, until the DOL proposed the Fiduciary Rule in 2016.<sup>49</sup> The Fiduciary Rule attempted to erase the blurred lines between brokers and investment advisers, treating all financial services professionals who provided investment advice as fiduciaries under ERISA.<sup>50</sup> Importantly, the proposed Fiduciary Rule marked the beginning of serious regulatory efforts to harmonize the legal framework applicable to brokers and investment advisers.

### III. EFFORTS TO “FIDUCIARIZE” INVESTMENT ADVICE

Prior to the DOL’s proposal of the Fiduciary Rule, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”)

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participate in transactions involving automation, they do not automatically take responsibility for the consequences from these transactions).

<sup>43</sup> See generally Laby, *supra* note 40 (discussing the increase in brokers advertising their advice services starting in the 1990s).

<sup>44</sup> See *id.* at 744.

<sup>45</sup> See *id.* at 733–34.

<sup>46</sup> See TREASURY BLUEPRINT, *supra* note 32, at 125–26.

<sup>47</sup> Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, 72 Fed. Reg. 55,126 (Sept. 28, 2007) (to be codified at 17 C.F.R. pt. 275); U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 71–72 (2009), [http://www.treasury.gov/initiatives/Documents/FinalReport\\_web.pdf](http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf) [<https://perma.cc/N2NB-AVW9>] [hereinafter FINANCIAL REGULATORY REFORM].

<sup>48</sup> See FINANCIAL REGULATORY REFORM, *supra* note 47, at 71.

<sup>49</sup> JOHN J. TOPOLESKI & GARY SHORTER, CONG. RESEARCH SERV., R44884, DEPARTMENT OF LABOR’S 2016 FIDUCIARY RULE: BACKGROUND AND ISSUES 1 (July 2017).

<sup>50</sup> See Definition of Term “Fiduciary”; Conflict of Interest—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550).



granted the SEC authority to harmonize the standard of care applicable to brokers and investment advisers to the extent they provided personalized retail investment advice.<sup>51</sup> To the confusion of many, the SEC failed to exercise its authority, choosing instead to allow the problematic gap in the legal treatment of brokers and investment advisers to persist.<sup>52</sup> However, once the DOL proposed the Fiduciary Rule, it forced the SEC to consider how it would intervene to similarly reduce conflicts of interests between financial advisors and retail investors.<sup>53</sup> As is to be expected, the response of financial advisors to heightened standards of conduct varied according to their allegiances—investment advisers strongly support leveling the playing field,<sup>54</sup> while brokers oppose the imposition of fiduciary obligation.<sup>55</sup> Yet, the approach of the DOL varies significantly from that of the SEC, with the former stridently emphasizing a near-complete elimination of conflicts of interests through the imposition of fiduciary obligations across the board,<sup>56</sup> and the latter attempting to straddle the line between brokers and investment advisers, without imposing the fiduciary obligations of the latter on the former.<sup>57</sup>

#### A. *The DOL and the Fiduciary Rule*

The first meaningful effort to harmonize the legal framework applicable to brokers and investment advisers came from the DOL through its authority under ERISA. ERISA is a federal statute aimed at protecting employees that

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<sup>51</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 913(f)–(g), 124 Stat. 1376, 1827–29 (2010).

<sup>52</sup> See Interview by Inv. Adviser Ass’n with Arthur Levitt, former Chairman, Sec. & Exch. Comm’n, in *Investment Advisers Act 75th Anniversary – Statements from Industry Leaders and Experts*, INST. FOR THE FIDUCIARY STANDARD (Sept. 8, 2015), [http://www.thefiduciaryinstitute.org/wp-content/uploads/2015/09/Arthur\\_Levitt\\_and\\_David\\_Tittsworth\\_on\\_IAA\\_at\\_75.pdf](http://www.thefiduciaryinstitute.org/wp-content/uploads/2015/09/Arthur_Levitt_and_David_Tittsworth_on_IAA_at_75.pdf) [<https://perma.cc/Q6NC-QQGA>].

<sup>53</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,580 (May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>54</sup> See Michael Joyce, *The SEC’s Best Interest Rule Doesn’t Go Far Enough*, WEALTH MGMT. (Sept. 21, 2018), <https://www.wealthmanagement.com/regulation-compliance/sec-s-best-interest-rule-doesn-t-go-far-enough> [<https://perma.cc/TXQ2-BGK9>] (stating that “many registered investment advisers supported the implementation of the stricter Department of Labor fiduciary rule”).

<sup>55</sup> See Tamar Frankel, *The Brokers’ War Against Fiduciary Duties*, VERDICT (Mar. 14, 2018), <https://verdict.justia.com/2018/03/14/brokers-war-fiduciary-duties> [<https://perma.cc/5ACB-2WPY>] (“[B]rokers are fighting hard to avoid bearing fiduciary duties to their clients.”).

<sup>56</sup> See, e.g., Definition of Term “Fiduciary”; Conflict of Interest—Retirement Investment Advice, 81 Fed. Reg. 20,946, 20,946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550).

<sup>57</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,575.

participate in private retirement plans.<sup>58</sup> The DOL is responsible for administering the statute, including promulgating regulations in accordance with the statute.<sup>59</sup> Importantly, ERISA contains a provision that deems someone a fiduciary to a retirement plan if she “renders investment advice for a fee or other compensation . . . with respect to any moneys or other property of such plan.”<sup>60</sup> In response to the (potential) ambiguity of whether incidental advice that brokers provide may transform them into fiduciaries, the DOL adopted regulations to identify when it deemed a financial advisor a fiduciary.<sup>61</sup> Prior to adoption of the Fiduciary Rule, the DOL defined a financial advisor as a fiduciary if and to the extent she provided personalized investment advice on a regular basis based on a mutual agreement.<sup>62</sup> This definition limited the designation of fiduciary to include investment advisers, who are already fiduciaries under the Advisers Act; and, importantly, to exclude brokers who only provide advice in relation to their sales.<sup>63</sup> Thus, while investment advisers were deemed fiduciaries under ERISA, brokers were subject to the suitability standard when dealing with retirement investors.<sup>64</sup>

Under ERISA, fiduciaries are subjected to significant constraints that, importantly, are designed to ensure the “undivided loyalty” of the fiduciary.<sup>65</sup> Indeed, the range of conflicting interest transactions ERISA prohibits is more

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<sup>58</sup> See Judson MacLaury, *A Brief History: The U.S. Department of Labor*, U.S. DEP’T LABOR, <https://www.dol.gov/oasam/programs/history/dolhistoxford.htm> [https://perma.cc/349F-QMHP] (“[ERISA] gave the Department a major role in protecting and improving the nation’s private retirement systems.”).

<sup>59</sup> See *Health Plans & Benefits*, U.S. DEP’T LABOR, <https://www.dol.gov/general/topic/health-plans> [https://perma.cc/YYU8-BJZL].

<sup>60</sup> Employee Retirement Income Security Act, 29 U.S.C. § 1002(21)(A) (2012). There are other activities that may make someone a fiduciary to a retirement plan, but this is the only one of significance for purposes of the Response.

<sup>61</sup> See Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. at 20,946 (final regulation defining “who is a fiduciary of an employee benefit plan under [ERISA]”).

<sup>62</sup> According to DOL regulation, a financial advisor is a fiduciary if she: (1) advises as to “the value of securities or other property, or make[s] recommendations as to the advisability of investing in, purchasing, or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement, or understanding” between the advisor and an employee benefit plan, (4) that such services “will serve as a primary basis for investment decisions with respect to” the plan’s assets, and (5) that “the advice will be individualized based on the particular needs of the plan or IRA.” Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. at 20,954–55.

<sup>63</sup> See *id.*; Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-6(3) (2012).

<sup>64</sup> See Definition of the Term “Fiduciary”; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. at 20,946.

<sup>65</sup> See Krug, *supra* note 23, at 356.

extensive than securities laws and regulations.<sup>66</sup> Nonetheless, because the original ERISA fiduciary definition only encompassed financial advisors who were already designated fiduciaries under securities laws (i.e., investment advisers) and because investment advisers receive asset-based compensation (as opposed to commission-based compensation), ERISA's stringent fiduciary limitations did not significantly affect the ability of investment advisers to service retirement accounts.<sup>67</sup>

This all changed in 2016 when the DOL adopted the Fiduciary Rule. The Fiduciary Rule expanded the scope of investment advice that would cause a financial advisor to be deemed a fiduciary under ERISA.<sup>68</sup> Per the new definition, an advisor is a fiduciary if she provides "investment advice to a retirement investor if, among other things, in exchange for a fee or other compensation, she recommends particular securities, investment strategies, or portfolio allocations to the investor."<sup>69</sup> In eschewing an agreement or that the advice be provided regularly, the Fiduciary Rule effectively brought brokers into the fold as ERISA fiduciaries if they provided any advice to retirement investors. And importantly, under the Fiduciary Rule, as advisors of retirement accounts, brokers would be required to provide conflict-free advice and to put their clients' needs above their self-interest.<sup>70</sup>

The Fiduciary Rule represented a significant shift in how brokers would be allowed to interact with retirement investors. As newly-designated ERISA fiduciaries, brokers would be subject to the same constraints as investment advisers.<sup>71</sup> Most notably, these restrictions included a prohibition on transaction-based compensation (such as commissions), unless the retirement advisor qualified for an exemption.<sup>72</sup> Under one such exemption—the best interest contract exemption—retirement advisors could continue to receive commission-based compensation, but any difference in the amount of commission paid to the retirement advisor had to be based on neutral factors.<sup>73</sup> Thus, any commission received must be the same for similar product types,

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<sup>66</sup> See *id.* at 353 (describing prohibited transactions under ERISA that are allowed under securities laws).

<sup>67</sup> *Id.* at 341 ("By imposing on these advisers a stringent standard of conduct and prohibiting them from entering into certain types of transactions, the statute establishes the general framework for fiduciaries' obligations to retirement investors.").

<sup>68</sup> See Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. at 20,997 (setting forth the DOL's revised interpretation of "investment advice").

<sup>69</sup> Krug, *supra* note 23, at 360.

<sup>70</sup> See Best Interest Contract Exemption, 81 Fed. Reg. 21,002, 21,007 (Apr. 8, 2016) (establishing that Advisers must adhere to the standards of fiduciary conduct and "put the interests of Retirement Investors first").

<sup>71</sup> See Krug, *supra* note 23, at 359.

<sup>72</sup> See Best Interest Contract Exemption, 81 Fed. Reg. at 21,002.

<sup>73</sup> See *id.* at 21,007 (explaining that the Best Interest Contract Exemption allows advisers to receive commission only if they adhere to procedures implemented to "prevent violations of the Impartial Conduct Standard").

unless there was an objective, neutral basis for the difference, such as the time or analytical effort required to advise the retirement investor.<sup>74</sup> The Fiduciary Rule, therefore, effectively eliminated many commission structures that allowed brokers to sell securities that were suitable, but possibly not in the best interest of the investor because of the brokers' commission.

The Fiduciary Rule was met with staunch opposition from its inception. It was finalized in April 2016 and, after numerous delays, full implementation was slated for July 1, 2019.<sup>75</sup> However, before the Fiduciary Rule could come to be, the Fifth Circuit Court of Appeals vacated it.<sup>76</sup> The challenge to the Fiduciary Rule came from the U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association ("SIFMA"), and others that contested the legal basis on which the executive branch adopted the Rule.<sup>77</sup> In March 2018, the Fifth Circuit held that the DOL's definition of financial advice was unreasonably broad and exceeded the scope of the Department's authority.<sup>78</sup> The DOL failed to appeal the Fifth Circuit's ruling to the Supreme Court and, consequently, the controversial Fiduciary Rule is dead.<sup>79</sup>

Despite its ultimate demise, the Fiduciary Rule was an important step in the path towards harmonization and fiduciarization of investment advice. Many brokerage firms reported that, despite the repeal of the Fiduciary Rule, they intend to maintain the changes they made to compensation and fee

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<sup>74</sup> See *id.* at 21,011 ("[T]he ongoing receipt of a Level Fee such as fixed percentage of the value of a customer's assets under management, where such values are determined by readily available independent sources or independent valuations . . .").

<sup>75</sup> See *News Release: U.S. Department of Labor Extends Transition Period for Fiduciary Rule Exemptions*, U.S. DEP'T LABOR (Nov. 27, 2017), <https://www.dol.gov/newsroom/releases/ebsa/ebsa20171127-0> [<https://perma.cc/QR75-CMER>].

<sup>76</sup> See *Chamber of Commerce of U.S. v. U.S. Dep't of Labor*, 885 F.3d 360, 363 (5th Cir. 2018).

<sup>77</sup> See *U.S. Chamber Examines Potential Harmful Impact of Fiduciary Regulation on Investors*, U.S. CHAMBER COM. (Feb. 20, 2015), <https://www.uschamber.com/press-release/us-chamber-examines-potential-harmful-impact-fiduciary-regulation-investors> [<https://perma.cc/YAV3-ZZH5>] (discussing the proposal of the Department of Labor to impose fiduciary duties on brokers); *Best Interest Standard*, SEC. INDUS. & FIN. MKTS. ASS'N, <https://www.sifma.org/explore-issues/best-interest-standard/> [<https://perma.cc/R78W-ZFJ8>] ("Together with the U.S. Chamber of Commerce . . . SIFMA filed a legal challenge to the Department of Labor's fiduciary standard of conduct rule for brokers and registered investment advisors . . .").

<sup>78</sup> See *Chamber of Commerce*, 885 F.3d at 387–88 ("DOL found 'in a long-extant statute an unheralded power to regulate a significant portion of the American economy.' And, although lacking direct regulatory authority over IRA 'fiduciaries,' DOL impermissibly bootstrapped what should have been safe harbor criteria into 'backdoor regulation.'").

<sup>79</sup> See Ross Snel, *R.I.P., DOL Fiduciary Rule*, BARRON'S (June 21, 2018), <https://www.barrons.com/articles/r-i-p-dol-fiduciary-rule-1529605320> [<https://perma.cc/75QD-HLZX>].

structures in anticipation of the Rule's implementation.<sup>80</sup> The Fiduciary Rule is a bell that cannot be unrung, as financial advisors are unlikely to revert to their pre-Fiduciary Rule business and compensation models.<sup>81</sup> Further, the uproar over the Fiduciary Rule has resulted in greater investor awareness of the potential conflicts that may exist in their advisor relationships.<sup>82</sup> Retail investors are now more likely to have greater expectations of their financial advisors.<sup>83</sup> Importantly, the increased public discourse on the Fiduciary Rule has heightened its regulatory importance. And as a result, the SEC in 2018 finally decided to exercise the authority granted to it under the Dodd-Frank Act to heighten the standard of conduct applicable to brokers.

### B. The SEC & Regulation Best Interest

Under Section 913(f) of the Dodd-Frank Act, the SEC is authorized to undertake rulemaking to address the “regulatory standards of care for brokers, dealers, investment advisers [and their associates] for providing personalized investment advice . . . to such retail customers.”<sup>84</sup> The SEC is also authorized under section 913(g) to adopt a uniform fiduciary standard applicable to both brokers and investment advisers.<sup>85</sup> In April 2018, the SEC put forward Regulation Best Interest (the “Regulation”), which is a package of proposed rulemakings and regulatory interpretations regarding the relationship between brokers and investment advisers, on the one hand, and retail investors on the other.<sup>86</sup> Notably, in proposing the Regulation, the SEC exercised its rulemaking authority under section 913(f) to impose standards of conduct on

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<sup>80</sup> See Charles Goldman, *Eulogy for the DOL Fiduciary Rule*, BARRON'S (Aug. 22, 2018), <https://www.barrons.com/articles/eulogy-for-the-dol-fiduciary-rule-1534955248> [<https://perma.cc/BA63-NNKA>] (explaining that “[m]any broker-dealers, probably most, changed processes and procedures for the better”).

<sup>81</sup> See David Trainer, *Even Without the Rule, Fiduciary Awareness Remains*, FORBES (Mar. 16, 2018), <https://www.forbes.com/sites/greatspeculations/2018/03/16/even-without-the-law-fiduciary-rule-awareness-remains/#f2174a5425af> [<https://perma.cc/EP3H-T4HP>].

<sup>82</sup> See Jeff Benjamin, *DOL Rule or Not, Be Prepared to Defend Investments, Fees Under a Fiduciary Standard*, INVESTMENTNEWS (Feb. 1, 2017), [www.investmentnews.com/article/20170201/FREE/170209983/dol-rule-or-not-be-prepared-to-defend-investments-fees-under-a](http://www.investmentnews.com/article/20170201/FREE/170209983/dol-rule-or-not-be-prepared-to-defend-investments-fees-under-a) [<https://perma.cc/87JH-QV8R>] (quoting Joe Taiber, managing partner of an investment consulting firm, who observed that “[r]egardless of what happens, the cat's out of the bag now, because clients are more educated” and that “[w]hether the full rule is implemented or delayed, it doesn't matter to the end user”).

<sup>83</sup> See *id.*

<sup>84</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 913(f), 124 Stat. 1376, 1827–29 (2010). Dodd-Frank also authorized the SEC to adopt a uniform fiduciary standard applicable to both brokers and investment advisers. In adopting Regulation Best Interest, however, the SEC did not exercise its authority under this provision. See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,675 (May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>85</sup> See Dodd-Frank Act § 913(g).

<sup>86</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,574.

brokers, rather than uniform fiduciary obligations for brokers and investment advisers per section 913(g).<sup>87</sup>

The proposed Regulation requires brokers to act in the “best interest” of retail investors and prohibits brokers from placing their own financial interests ahead of their clients’ interests.<sup>88</sup> Notably, the Regulation does not go as far as the Fiduciary Rule with respect to banning commission-based compensation.<sup>89</sup> Recognizing that commissions constitute the most prevalent form of broker compensation, the SEC determined that prohibiting commissions would be more harmful than beneficial for retail investors.<sup>90</sup> However, the Commission also noted that the commission-based model is innately conflicted, and the current suitability standard may not sufficiently protect retail investors.<sup>91</sup> Thus, the Regulation aims to strike a balance between maintaining commissions as a viable compensation model for brokers while improving retail investor protection.

To address the embedded conflicts that accompany commission-based compensation plans and enhance retail investor protection, the Regulation imposes additional requirements on brokers in their interactions with retail clients.<sup>92</sup> Although the Regulation fails to define “best interest,” it states that the determination as to whether a broker acted in the best interest of her client will be made based on the facts and circumstances at the time the investment advice is provided.<sup>93</sup> In place of a definition, the Regulation provides a three-

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<sup>87</sup> See *id.* at 21,575 (“[W]e are proposing a new rule . . . [t]hat all broker-dealers . . . act in the best interest of the retail customer at the time the recommendation is made *without placing the financial or other interest of the broker-dealer . . . ahead of the interest of the retail customer* (‘Regulation Best Interest’).”) (emphasis added).

<sup>88</sup> See *id.*

<sup>89</sup> See Sarah O’Brien, *Labor Department Won’t Enforce Investor Protection Rule After Court Decision*, CNBC (Mar. 19, 2018), <https://www.cnbc.com/2018/03/19/dol-shelving-enforcement-of-fiduciary-rule-after-court-decision.html> [<https://perma.cc/9LDE-RHNT>] (“[The fiduciary rule] requires advisors and brokers to put their clients’ interests before their own when advising on retirement accounts such as 401(k) plans and individual retirement accounts.”).

<sup>90</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,580–81 (“[B]roker-dealers that would be considered to be a ‘fiduciary’ under the DOL Fiduciary Rule . . . would be prohibited from receiving common forms of broker-dealer compensation (notably, transaction-based compensation), which would effectively eliminate a broker-dealer’s ability or willingness to provide investment advice with respect to investors’ retirement assets.”).

<sup>91</sup> See *id.* at 21,575 (“Like many principal-agent relationships, the relationship between a broker-dealer and an investor has inherent conflicts of interest, which may provide an incentive to a broker-dealer to seek to maximize its compensation at the expense of the investor it is advising.”).

<sup>92</sup> See *id.*

<sup>93</sup> See *id.* at 21,587 (explaining that the regulation does not intend to define “best interest” since the recommendation depends on the “facts and circumstances of the particular recommendation and the particular retail customer”).

part framework that serves as a guide for brokers to know if they have acted in their client's best interest.<sup>94</sup>

To qualify for the Regulation's safe harbor, first, a broker must provide written disclosure of the material terms of the broker-client relationship, including fees and any material conflicts of interests connected to the broker's investment advice.<sup>95</sup> The broker is obligated to make these disclosures when the investor opens the account, periodically as needed to update prior disclosures, and at the time of sale if there are material conflicts related to the security being sold.<sup>96</sup>

Second, the broker must exercise reasonable prudence and care to determine whether the security is in the best interest of the customer.<sup>97</sup> Thus, the broker may no longer merely consider whether the investment is suitable for the client; instead, she must determine if it is in the client's best interest, thereby raising the broker's obligations.<sup>98</sup> To comply with this requirement, a broker is not required to evaluate all potential investments; but her investigation must be sufficiently broad to constitute reasonable diligence.<sup>99</sup> Further, the broker must also obtain client-specific information regarding the investor's risk appetite, investment goals, financial circumstances, and other relevant information.<sup>100</sup> Notably, the standard of care required cannot be waived by the client, nor can the broker cure any failure to meet this obligation through disclosure.<sup>101</sup>

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<sup>94</sup> See *id.* at 21,681.

<sup>95</sup> See *id.* at 21,681 (“[The broker-dealer must], prior to or at the time of such recommendation, reasonably disclose in writing all material conflicts of interest associated with the recommendation.”).

<sup>96</sup> See 83 Fed. Reg. at 21,605 (establishing that disclosure “may be achieved through a variety of approaches: (1) at the beginning of a relationship . . . ; (2) on a regular or periodic basis . . . ; (3) at other points . . . ; and/or (4) at multiple points in the relationship or through a layered approach to disclosure”).

<sup>97</sup> See *id.* at 21,589 (“[T]he BIC Exemption’s best interest standard incorporates ‘objective standards of care and undivided loyalty’ that would require adherence to a professional standard of care in making investment recommendations that are in the investor’s best interest . . .”).

<sup>98</sup> This obligation closely tracks FINRA’s existing suitability standard found in FINRA Rule 2111. See Hillel T. Cohn et al., *SEC Proposes a New Standard of Care for Broker-Dealers: Regulation Best Interest*, MORRISON FOERSTER (Apr. 24, 2018), <https://www.mofo.com/resources/publications/180424-sec-regulation-best-interest.html> [<https://perma.cc/33M7-SEX5>].

<sup>99</sup> See Regulation Best Interest, 83 Fed. Reg. at 21,609 (“Under the Care Obligation . . . [it] would not require a broker-dealer to analyze all possible securities, all other products, or all investment strategies to recommend the single ‘best’ security or investment strategy for the retail customer . . .”).

<sup>100</sup> See *id.* at 21,611 (listing elements that brokers have to consider regarding the client’s characteristics and circumstances).

<sup>101</sup> See *id.* at 21,595 (“[A] broker-dealer would not be able to waive compliance with the rule’s obligation to act in the best interest of the retail customer at the time a

Third, the Regulation requires brokers to implement policies and procedures reasonably designed to identify conflicts of interest and to disclose material conflicts to retail investors in a timely manner.<sup>102</sup> The policies and procedures must be capable of capturing new conflicts as they arise and must address how brokers will mitigate against compensation-based conflicts.<sup>103</sup> Per the Regulation, disclosure will be insufficient with respect to certain conflicts such as those arising from sales incentives. In these instances, brokers will be required to eliminate the source of the conflict.<sup>104</sup> Thus, despite choosing not to prohibit commission-based compensation, the Regulation places the burden on brokers to evaluate and, in some instances, minimize or eliminate conflicts of interest.

The Regulation also requires brokers and investment advisers to provide retail investors with a “client relationship summary,” Form CRS.<sup>105</sup> The summary would include information regarding: (i) the relationships, accounts, and services the firm offers; (ii) the standard of conduct applicable to offered services; (iii) the fees for and costs of services; (iv) comparisons between brokers and investment advisers services, fees, and standard of conduct; (v) conflicts of interests related to the broker’s services; (vi) access to additional information, such as legal or disciplinary actions against the brokerage firm and its brokers; and (vii) required questions a retail investor may want to ask.<sup>106</sup>

With Regulation Best Interest, the SEC signaled its willingness to enter the ongoing conversation regarding the standard of conduct applicable to investment advisers and brokers. However, in formulating a new standard, it is questionable whether the Commission has truly moved the ball forward. On

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recommendation is made and the specific obligations thereunder, nor can a retail customer agree to waive her protection under Regulation Best Interest.”).

<sup>102</sup> See *id.* at 21,617 (explaining that the Conflict of Interest Obligations require a broker-dealer to disclose to the client all material conflict of interest related to the recommendation).

<sup>103</sup> See *id.*

<sup>104</sup> See Cohn et al., *supra* note 98 (“Disclosure alone will not suffice in the case of conflicts that relate to financial incentives or the manner in which associated persons are compensated.”); see also Regulation Best Interest, 83 Fed. Reg. at 21,619 (“A broker-dealer seeking to address its Conflict of Interest Obligations through elimination of a material conflict of interest could choose to eliminate the conflict of interest entirely, for example by removing incentives associated with a particular product . . .”).

<sup>105</sup> See Hester M. Peirce, Comm’r, Sec. & Exch. Comm’n, What’s in a Name? Regulation Best Interest v. Fiduciary, Remarks at the National Association of Plan Advisors D.C. Fly-In Forum (July 24, 2018), <https://www.sec.gov/news/speech/speech-peirce-072418> [<https://perma.cc/8XZ9-YG78>] (“New Form CRS . . . is a four-page (at most) document to be delivered in addition to—not in place of—any of the current disclosure documents that broker-dealers and advisers currently provide.”).

<sup>106</sup> See Form CRS Relationship Summary; Amendments to Form ADV; Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, 83 Fed. Reg. 21,416, 21,536 (proposed May 9, 2018) (to be codified at 17 C.F.R. pts. 240, 249, 275, 279).



the one hand, the best interest standard and the accompanying disclosures are enhancements over the current suitability standard. However, on the other hand, by failing to harmonize the obligations of standard of conduct applicable to investment advisers and brokers, the SEC may have missed an opportunity to truly eliminate the confusion retail investors face in their dealings with financial service professionals. In Part IV, this Response briefly explores the implications of the failed Fiduciary Rule and the proposed Regulation Best Interest for retail investors.

#### IV. IMPLICATIONS FOR RETAIL INVESTORS

As Professor Edwards details in his paper, conflicted advice is a significant problem for retail investors and the wider economy.<sup>107</sup> Regulation Best Interest and the Fiduciary Rule sought to address the conflicted advice problem Professor Edwards discusses,<sup>108</sup> albeit in different ways. However, both proposals fall short in addressing the problem of conflicted advice and the attendant consequences of such advice. Although the Fiduciary Rule has been vacated and ultimately will not be part of the regulatory landscape, it is useful to consider how it could have altered the relationship between retail investors and financial advisors, particularly in comparison to Regulation Best Interest. Part IV examines whether and to what extent the Fiduciary Rule and Regulation Best Interest effectively (i) address the problem of conflicted advice, (ii) reduce investor confusion, and (iii) increase investor protection.

##### A. *Conflicted Advice*

In light of the issues that stem from conflicted advice, it is important to consider whether and to what extent both the Fiduciary Rule and Regulation Best Interest address the issue of conflicted advice.

The approach of the Fiduciary Rule to the problem of conflicted investment advice was, more or less, straightforward—retirement investment advisors, as fiduciaries, were required to avoid all conflicts of interest.<sup>109</sup> This requirement would have implemented a near-complete ban on commission-based compensation, unless an exception was available. The Fiduciary Rule, therefore, would have established a bright-line stance towards conflicted advice—it simply would not have been allowed.<sup>110</sup> On the positive side, the bright-line the Fiduciary Rule created would have left very little room for conflicted advice to exist. Brokers would have been charged with putting the interests of their clients first, which could not be accomplished with many

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<sup>107</sup> See Edwards, *supra* note 1, at 183.

<sup>108</sup> See generally Peirce, *supra* note 105 (discussing the theoretical underpinnings of each proposed regulation).

<sup>109</sup> See *supra* note 70 and accompanying text.

<sup>110</sup> It is more accurate to say a somewhat bright-line rule, given the exceptions possible. See *supra* notes 72–74 and accompanying text.

commission-based compensation schemes.<sup>111</sup> The hard stance of the Fiduciary Rule, therefore, would eliminate the problem of conflicted advice entirely, freeing retirement investors from the concerns that their brokers may be steering them towards puzzling product choices, which may not be in the investors' best interests but would compensate the brokers handsomely. Despite these benefits, to some commentators the elimination of commission-based products would not have resulted in a net benefit to retail investors.<sup>112</sup> Specifically, the Fiduciary Rule would have limited the investment products available to retirement investors and, possibly, forced some retirement investors with less assets out of the marketplace for retirement investment advice.<sup>113</sup>

The SEC's proposed approach to conflicted advice may be viewed as more of a middle-ground. Regulation Best Interest does not ban conflicted compensation schemes, such as commissions, but it requires brokers to take more active steps in mitigating and, in some cases, eliminating conflicts of interest.<sup>114</sup> By requiring that brokers comply with the three-part framework to be entitled to the presumption that they acted in the best interests of their clients, Regulation Best Interest imposes a standard of conduct that exceeds the existing suitability standard.<sup>115</sup> The Regulation permits transaction-based compensation plans, which are innately conflicted, but imposes a regime in which conflicts are disclosed and managed.<sup>116</sup> The proposed framework, therefore, seeks to balance the interest of brokers to maintain commissions as a viable compensation method against the need to protect investors from the ills of conflicted advice. The question then becomes whether the proposed framework minimizes the effects of conflicted advice.

In avoiding a prescriptive, bright-line standard, akin to the Fiduciary Rule, the SEC grants brokers some flexibility in designing compliance standards and

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<sup>111</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,620 (May 9, 2018) (to be codified at 17 C.F.R. pt. 240) ("[B]roker-dealer financial incentives—including internal compensation structures and compensation arrangements with third parties—create inherent conflicts that . . . may be difficult, if not impossible, to effectively manage through disclosure alone, or to eliminate.").

<sup>112</sup> See Paul R. Walsh & David W. Johns, *Can the Retail Investor Survive the Fiduciary Standard?*, 87 ST. JOHN'S L. REV. 437, 446–47 (2013) (explaining that if the commission-based products are eliminated, brokers would have to be compensated through a percentage fee. Therefore, brokers would require investors to have a minimum amount of assets and this would harm small investors who would not be able to afford a broker of investment advisor).

<sup>113</sup> See *Chamber of Commerce of United States v. United States Dep't of Labor*, 885 F.3d 360, 368 (5th Cir. 2018).

<sup>114</sup> See Cohn et al., *supra* note 98 ("Rather than prohibit all such conflicts, however, the SEC is proposing more rigorous requirements to manage and disclose conflicts of interest, including conflicts that arise from the manner in which a broker-dealer is compensated.").

<sup>115</sup> See *supra* note 98 and accompanying text.

<sup>116</sup> See *supra* Part III.B.

procedures that are suitable for their business and clients. The Regulation allows brokers to continue acting as principals for their own accounts in their dealings with retail investors but prohibits brokers from placing their interests before their clients'.<sup>117</sup> Thus, brokers may continue to receive commission-based compensation, provided that it is nonetheless in their clients' best interests. Yet, it is questionable whether this fluid standard meaningfully mitigates against the conflicted advice problem. Setting aside the lack of definition of "best interest" (addressed in greater detail below), the Regulation falls short of establishing a fiduciary standard, which leaves retail investors exposed to significant conflicts of interest. The Regulation's proposed three-part framework establishes a way for brokers to earn a safe harbor but, arguably, does not do enough to protect retail investors from receiving conflicted advice. By providing brokers with a "check-the-box" mechanism to comply with their obligations to act in the client's "best interest," the Regulation fails to impose enough of a burden on brokers to reduce their conflicts of interest.

Furthermore, in dealing with clients, brokers are not required to provide full and fair disclosure of all material conflicts; rather, they are obliged to provide reasonable disclosures.<sup>118</sup> The standard of reasonableness, while appropriate for some situations, may not be the best standard when trying to mitigate against conflicts of interest.<sup>119</sup> Regulation Best Interest, therefore, may have moved the needle somewhat on the issue of conflicted advice, but it may not be enough to provide meaningful investor protection. Indeed, it is questionable whether a disclosure-based regulatory framework will effectively address the problem of conflicted advice.<sup>120</sup> This is true particularly in the face of the unequal power dynamic between brokers and their clients and the unavoidable conflicts of interest that accompany transaction-based compensation.<sup>121</sup>

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<sup>117</sup> See Cohn et al., *supra* note 98 ("Under the proposed regulation, broker-dealers and their associated persons would be required to act in the 'best interest' of their retail clients and would be prohibited from placing their interests ahead of such clients. Broker-dealers could continue to act in a principal capacity in relation to their customers . . .").

<sup>118</sup> See Kara M. Stein, Comm'r, Sec. & Exch. Comm'n, Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Certain Names or Titles, and Commission Interpretation Regarding the Standard of Conduct for Investment Advisers (Apr. 18, 2018), <https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818> [<https://perma.cc/Z7F6-ZEG2>].

<sup>119</sup> See *id.* (discussing the "safe harbor" implied by the best interest obligation, and stating that the SEC could have proposed a more effective standard to mitigate conflict of interest in the broker-dealer and client relationship).

<sup>120</sup> See *supra* Part III.C.

<sup>121</sup> See Cohn et al., *supra* note 98 (describing how conflicts are inherent in the broker-dealer business model).

### B. *Investor Confusion*

Another implication of the Fiduciary Rule and Regulation Best Interest is their effect on minimizing investor confusion. To the extent investors are less confused about from whom they receive advice, it is possible investors may be better able to guard themselves against the negative impact of conflicted advice. That is to say, if an investor knows that the advice she receives is conflicted or potentially conflicted, she may be warier of accepting or following the advice.

The Fiduciary Rule would have harmonized the standard of conduct applicable to brokers and investment advisers—all retirement investment advisors, regardless of classification, would have been fiduciaries of their clients.<sup>122</sup> However, owing to the DOL's limited authority, the Rule's harmony would have only extended to retirement investment accounts.<sup>123</sup> Thus, on the one hand, the Fiduciary Rule would have reduced the potential for investor confusion by imposing a uniform fiduciary standard on retirement investment advisors. But, on the other hand, the Fiduciary Rule would have exacerbated potential investor confusion, because the applicable standards of conduct would vary based on whether the investor received advice from a broker versus an investment adviser and whether the advice was regarding a retirement or non-retirement account. The Fiduciary Rule, therefore, would have created both more clarity and more confusion regarding the level of protection to which retirement investors would be entitled. An investor would receive the same level of protection for retirement-related advice, without regard for whether the advice came from a broker or an investment adviser. However, for non-retirement advice, she would remain subject to the confusing legal delineation between brokers and investment advisers.

Yet, it is important to note that most investors are likely to seek investment advice, for both retirement and non-retirement accounts, from a single financial advisor. Thus, in order to comply with the Fiduciary Rule, most financial advisors would be forced to raise their standards all-around regardless of the type of account a retail client may have. Meaning, rather than try to comply with conflicting standards, brokers likely would have self-imposed the Fiduciary Rule's higher standards even when advising non-retirement accounts. In sum, despite being a half-measure, the Fiduciary Rule took a meaningful step towards minimizing the existing conflicts of interest within the DOL's sphere of authority (i.e., the retirement investor-financial advisor relationship), which likely would have permeated investor advice beyond the scope of ERISA.

In proposing the Regulation, the SEC asserts that it seeks to minimize the gap that exists in how much protection investors believe they have when

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<sup>122</sup> See Krug, *supra* note 23, at 359 (explaining that the Fiduciary Rule treats brokers like other ERISA fiduciaries).

<sup>123</sup> See *supra* Part III.A.

receiving advice and how much protection they actually have.<sup>124</sup> However, in addressing the disparity, the SEC eschews the well-known fiduciary standard for the unknown, newly created “best interest” standard.<sup>125</sup> The Regulation and its new standard create or exacerbate three sources of potential investor confusion.

First, the Regulation fails to harmonize the standard of conduct applicable to investment advisers and brokers who provide investment advice.<sup>126</sup> Despite acting in a substantially similar role as investment advisers, Regulation Best Interest does not impose on brokers who give investment advice the same fiduciary obligations as investment advisers.<sup>127</sup> This only serves to exacerbate the existing confusion regarding the level of protection that is available to retail investors in the marketplace.

Second, “best interest” is undefined in the Regulation.<sup>128</sup> With the best interest standard, retail investors are not much better off in understanding what duties a broker may owe them and, likely, the broker’s obligations are *still* less in reality than investors expect, since the broker is not a fiduciary.<sup>129</sup>

Third, the name of the standard suggests that brokers are free from conflicts. To a layperson, saying that someone must act in your best interest implies that (i) the person is your agent (to use a legal phrase) and that (ii) your interests must supersede hers. But neither of these things is true under Regulation Best Interest.<sup>130</sup> Thus, the very name of the standard deepens investor confusion, by misleading retail investors as to the legal obligations of their brokers in providing investment advice.

In sum, despite claiming to want to minimize investor confusion, it is questionable whether Regulation Best Interest actually does this. In creating a new standard of conduct, the SEC has exacerbated the problem of investor confusion without truly closing the gap between investor expectation and the reality of investor protection. And, indeed, because of its misleading name, Regulation Best Interest may have worsened investor confusion.

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<sup>124</sup> See *SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships with Investment Professionals*, U.S. SEC. & EXCH. COMM’N (Apr. 18, 2018), <https://www.sec.gov/news/press-release/2018-68> [<https://perma.cc/DHQ6-N5Y9>] (explaining that the Regulation Best Interest intends to “make it clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer” and to avoid investors’ confusion regarding “their relationships with investment professionals”).

<sup>125</sup> See *supra* Part III.B.

<sup>126</sup> See Peirce, *supra* note 105 (comparing Regulation Best Interest to the fiduciary duty of investment advisers).

<sup>127</sup> See *supra* note 87 and accompanying text.

<sup>128</sup> See Stein, *supra* note 118 (“Despite repeated requests to define what best interest means in the rule text, it was decided that there was no need to define it.”).

<sup>129</sup> See *supra* notes 84–87 and accompanying text.

<sup>130</sup> See *supra* Part III.B.

### C. Investor Protection

Both the Fiduciary Rule and Regulation Best Interest directly implicate investor protection. The pertinent question one must ask is whether the proposed changes provide investors with greater protection either (i) against conflicted advice, or (ii) against the possible negative consequences of self-interested investment advice.

The Fiduciary Rule transformed all retirement investment advisors into fiduciaries of their clients.<sup>131</sup> Under the Fiduciary Rule, brokers would owe their retirement clients their undivided loyalty, which meant commission-based compensation was prohibited.<sup>132</sup> Undoubtedly, the Fiduciary Rule would have increased the protection available to retirement investors by imposing fiduciary obligations on brokers, thereby ensuring a basic level of protection for all retirement investors regardless of whether they receive investment advice from a broker versus an investment adviser. However, as stated prior, this greater level of protection would have been limited to brokers who provided retirement investment advice,<sup>133</sup> thus limiting the effectiveness of the Fiduciary Rule. Thus, the Fiduciary Rule would have provided investors with protection against both conflicted advice and the costs of self-interested advice; however, owing to the limited scope of ERISA this protection would not have been market-wide.

A primary goal of Regulation Best Interest is to raise the standard of conduct applicable to brokers;<sup>134</sup> and the best interest standard does, indeed, impose a standard of conduct higher than the current suitability rule.<sup>135</sup> Brokers are no longer allowed to steer clients towards a high-commission product when a substantially similar product that pays a lower commission is also available.<sup>136</sup> Thus, a broker's self-interest cannot be the predominant motivating factor in her advice to retail investors.<sup>137</sup> Further, in requiring brokers to mitigate or eliminate particularly egregious conflicts of interest,<sup>138</sup> Regulation Best Interest reduces the potential for conflicted advice. It places an affirmative duty on brokers to assess existing conflicts and to take steps necessary to minimize the impact of these conflicts on their client

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<sup>131</sup> See O'Brien, *supra* note 89.

<sup>132</sup> See Cohn et al., *supra* note 98 ("Broker-dealers making any kind of investment recommendation to retail retirement investors would be deemed fiduciaries and would be prohibited from acting in a principal capacity or from receiving commissions . . .").

<sup>133</sup> See *supra* Part III.A.

<sup>134</sup> See Cohn et al., *supra* note 98 ("The proposed Regulation Best Interest would establish a higher standard of care and disclosure for broker-dealers when making recommendations to retail customers . . .").

<sup>135</sup> See *id.*

<sup>136</sup> See *id.* ("The Regulation states that a broker-dealer and its associated persons may not place their own interests ahead of the interests of a retail customer.").

<sup>137</sup> See Regulation Best Interest, 83 Fed. Reg. 21,574, 21,585–87 (May 9, 2018) (to be codified at 17 C.F.R. pt. 240).

<sup>138</sup> See *supra* notes 102–104 and accompanying text.

relationships.<sup>139</sup> Lastly, Form CRS provides investors with more information about who they are transacting with (i.e., whether their financial services professional is a broker or an investment adviser), the applicable fees for the services they are receiving, and past disciplinary information on the broker and/or her associated firm.<sup>140</sup> More information for retail investors about the persons to whom they have entrusted their investment is certainly a welcomed change and may empower investors to be more critical of their brokers' investment advice.

However, despite these positive attributes, there are legitimate concerns as to whether Regulation Best Interest is a meaningful improvement on the status quo. First, it is questionable whether and to what extent the best interest standard is more protective of investors than the suitability standard. The best interest standard does not rise to the level of fiduciary duties, but it is supposed to be more than the suitability standard. Yet, the best interest standard is modeled so closely on the suitability standard, with the wording of the former tracking the wording of the latter to a significant degree.<sup>141</sup> Thus, it is unclear just *how* the best interest standard differs from the suitability standard.<sup>142</sup> As the proposed Regulation is revised and eventually adopted, it remains to be seen what additional measure of protection the best interest standard provides that supersedes the existing standard.

Second, Regulation Best Interest relies heavily on disclosure to protect retail investors. Disclosure is only as good as it is effective and many, including some SEC Commissioners, have raised concerns about whether the disclosure-heavy standard of conduct will have any meaningful effect on retail investors.<sup>143</sup> As studies have shown, investors are not likely to read and/or understand disclosures that are given to them.<sup>144</sup> Given the importance of disclosure in the implementation of the best interest standard, the SEC ought

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<sup>139</sup> See *id.*

<sup>140</sup> See Peirce, *supra* note 105.

<sup>141</sup> See *supra* note 98, and accompanying text.

<sup>142</sup> See Stein, *supra* note 118 (“[T]his proposal allows a broker-dealer to meet its ‘best interest’ obligation by doing three things: providing some ‘reasonable’ disclosure about its relationship with the customer, fulfilling what are essentially the existing standards for broker-dealer conduct (i.e., suitability) . . . .”); see also Ann Marsh, *Fiduciary Fatigue Settles Over SEC Best Interest Rule Debate*, FIN. PLAN. (Aug. 9, 2018), <https://www.financial-planning.com/news/sec-best-interest-rule-hampered-by-fiduciary-fatigue> [<https://perma.cc/5UND-2MFP>] (criticizing the new Regulation Best Interest, claiming that it is no different from the suitability standard) (quoting Professor James Cox).

<sup>143</sup> See Peirce, *supra* note 105 (discussing the proposed Regulation Best Interest and questioning whether the imposition of a higher standard of conduct would result “in retail customers losing access to advice”).

<sup>144</sup> Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure*, 2011 WIS. L. REV. 1059, 1070–71 (2011) (“[L]ay investors typically do not read disclosure documents when investing in securities, meaning that investors who receive a document indicating that their stock broker owes them no fiduciary duty often (a) will not even read it . . . or (b) if they do read it, they will not go to the trouble of figuring out what the heck it means . . .”).

to ensure that the disclosures are as effective as possible in conveying the necessary information to investors. But, even the most effective disclosures may not be enough to protect investors without a more robust investor protection regime. Thus, reasonable minds may differ on whether the proposed framework of Regulation Best Interest enhances investor protection in any meaningful way.

## V. CONCLUSION

The conflicted advice problem that faces retail investors seeking advice from brokers is persistent; it poses significant challenges for investors and regulators alike. Conflicted investment advice cost investors millions of dollars and has resulted in significant capital diversions within the larger economy. Recent efforts to solve this problem, however, have been plagued with shortcomings. The Fiduciary Rule was a bright line rule that threatened the viability of commission-based compensation for retail investment advice. It removed conflicts almost entirely from the broker-investor relationship. But in doing so, it arguably would have curtailed investor choice and possibly would have increased investor costs. With Regulation Best Interest, the SEC aimed to strike a middle ground. However, its attempts demonstrate the difficulties in balancing investor protection against industry interests. As a proposal, Regulation Best Interest is a step in the right direction, but it is insufficient. In spite of the Regulation, retail investors will nonetheless face significant conflicts of interest, confusion about the protections they are afforded in the market, and less actual protection than the fiduciary standard. To effectively address the conflicted advice problem, therefore, the SEC must decide which it values more: protecting investors protection or maintaining the viability of commission-based compensation. It is only in truly deciding between these two competing interests that Regulation Best Interest (or any future attempts to heighten the brokers' standard of conduct) will be able to clarify the relationship between retail investors and their financial advisors.